[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND THE REPUBLIC OF TUNISIA

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON JUNE 14, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty and proposed protocol between the United States and the Republic of Tunisia ("Tunisia"). The proposed treaty was signed on June 17, 1985, and the proposed protocol was signed on October 4, 1989. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty and protocol on June 14, 1990.

No income tax treaty between the two countries is currently in force. The proposed treaty (as modified by the proposed protocol) is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model"), and the model income tax treaty of the Organization of Economic Cooperation and Development ("OECD model"). The proposed treaty contains certain substantive deviations from those documents, however.

The first part of the pamphlet summarizes the principal provisions of the proposed treaty and protocol. The second part presents a discussion of issues that the proposed treaty presents. The third part provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in part four by a detailed, article-by-article explanation of the proposed treaty and protocol.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Republic of Tunisia* (JCS-16-90), June 13, 1990.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and the Republic of Tunisia ("Tunisia") are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are achieved principally by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty provides that a country will not tax business income derived from sources within that country by residents of the other country unless the business activities in the first country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country are not required to pay tax in the other country unless their contact with that other country exceeds specified minimums (Articles 14, 15, 17, and 20). The proposed treaty provides that dividends, interest, royalties, and certain gains derived by a resident of either country from sources within the other country generally are taxable by both countries (Articles 10, 11, 12, and 13). However, dividends, interest, and royalties received by a resident of one country from sources within the other country generally are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, relief from the potential double taxation generally is provided for the by the country of residence allowing a foreign tax credit (Article 23).

Like other U.S. tax treaties, the proposed treaty contains a "saving clause" (Article 22(2)). Under this provision, the United States generally retains the right to tax its citizens and residents as if the treaty had not come into effect. In addition, the proposed treaty contains the standard provision that it does not apply to deny a taxpayer any benefits he is entitled to under the domestic law of the country or under any other agreement between the two countries (Article 22(1)); that is, the treaty only applies to the benefit of taxpayers.

The proposed treaty also contains a non-discrimination provision (Article 24) and provides for administrative cooperation and exchange of information between the tax authorities of the two countries to avoid double taxation and to prevent fiscal evasion with respect to income taxes (Article 26).

Differences between proposed treaty and model treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model and OECD model treaties. Some of these differences are as follows:

(1) The U.S. excise tax on insurance premiums paid to a foreign insurer is not covered by the proposed treaty. Although this is consistent with several older U.S. tax treaties, the U.S. model and some recent U.S. treaties, such as the treaties with the United Kingdom, France, and Hungary, generally cover this excise tax. In addition, the excise taxes imposed with respect to private foundations are not covered by the proposed treaty, although they are covered by the U.S. model.

(2) Under the U.S. model, the term "United States" is defined as the United States of America, but does not include any U.S. possession or territory. The proposed treaty's definition of this term extends beyond the definition stated in the U.S. model to include those parts of the adjacent seas over which the United States may, in accordance with international law, exercise rights with respect to the natural resources of the seabed and marine subsoil. However, the U.S. model definition is understood to also include these territories.

(3) U.S. citizens who are not treated as U.S. residents under the proposed treaty's residence rules (Article 4) generally are not covered by the proposed treaty. The U.S. model does cover such nonresident U.S. citizens; however, the United States rarely has been able to negotiate coverage for them in its income tax treaties. The proposed treaty treats the governments of the two countries as treaty country residents (i.e., it extends treaty benefits to each government), whereas the U.S. model makes no mention of the respective treaty countries' governments in its article on residence.

(4) Both the proposed treaty and the U.S. model provide that a person who is taxable under the laws of a country by reason of that person's residence is considered a resident of that country for treaty purposes. The proposed treaty limits the application of this rule, however, in the case of certain persons who are treated as U.S. residents under the Code. That provision states that a U.S. citizen or an alien admitted to the United States for permanent residence (i.e., a "green card" holder) is considered a resident of the United States for purposes of the proposed treaty only if that individual only if that person has a substantial presence, a permanent home, or an habitual abode in the United States.

(5) The U.S. model specifies that in the case of income earned by a pass-through entity (such as a partnership, estate, or trust), the entity will be treated as a resident of a treaty country only to the extent that the income derived by the entity is subject to tax in that country as the income of a resident, either in the hands of the entity, or in the hands of the entity's partners or beneficiaries. The proposed treaty omits this language, but it is understood that a

similar rule will apply to income derived by partnerships. It is further understood that a similar rule regarding income earned by trusts or estates is not relevant to the proposed treaty because those entities are not recognized under Tunisian law.

(6) Under the U.S. model, a dual resident corporation is automatically considered a resident of the country under whose laws it was created and is, thus, entitled to only the treaty benefits that other corporate residents of that country receive.[2] By contrast, the proposed treaty provides that the determination of a single country of residence with respect to a dual resident company is effected through mutual agreement by the competent authorities of the two countries.

(7) The definition of a "permanent establishment" in the proposed treaty is broader, in certain respects, than the corresponding definitions in the U.S. model, the OECD model, and in many existing U.S. treaties. For example, the proposed treaty treats as a permanent establishment a building site, construction, assembly, or installation project, or an installation, drilling rig, or ship used for the exploration or exploitation of natural resources (or supervisory activities in connection therewith) that lasts for more than 183 days during any 365-day period. The U.S. and OECD models provide for a 12-month period before a permanent establishment is created in such cases (except that both models are silent with respect to certain related supervisory activities). Similar provisions reducing the 12-month threshold are found in some other U.S. tax treaties.

(8) The proposed treaty contains a provision, not found in either the U.S. or OECD model treaties, stating that an insurance company which is a resident of one of the countries is treated as having a permanent establishment in the other country if it uses an employee or other representative (other than a broker or independent agent acting in his or her ordinary course of business) in such other country for the purposes of receiving premiums from, or insuring risks in, that other country.

(9) The proposed treaty omits the standard treaty provision that provides investors in real property in the country not of their residence with an election to be taxed on a net basis with respect to income from such investments. Current U.S. law independently provides a net-basis taxation election to foreign persons (Code secs. 871(d) and 882(d)). It is understood that, as a general rule, Tunisian law provides for taxation of income from real property on a net basis as well.

(10) The proposed treaty does not contain a definition of the term "business profits," although certain categories of business profits are defined in various articles. Many U.S. treaties and the U.S. model define business profits to include income from rental of tangible personal property and from rental or licensing of films or tapes. The proposed treaty, as amended by the proposed protocol, includes payments for the use of, or the right to use, industrial, commercial, or scientific equipment as royalties, which generally are subject to a 10-percent source-country withholding tax imposed

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[2] Under the OECD model, a dual resident corporation is automatically considered a resident of the country in which its place of effective management is situated.

on a gross basis. Furthermore, income from rental or licensing of films or tapes also is treated as royalties under the proposed treaty and protocol, subject to a 15-percent source-country withholding tax.

(11) The proposed treaty, the U.S. model, and the OECD model each permit a reasonable allocation to a permanent establishment of certain expenses (e.g., general and administrative expenses) incurred by worldwide operations of the person having the permanent establishment. Although the U.S. model makes specific reference to the allowance of deductions for certain general and administrative, research and development, and interest expenses, whether incurred in the country in which the permanent establishment is situated or otherwise, the proposed treaty and the OECD model specifically mention only general and administrative expenses in this context. In addition, unlike the two model treaties, but like the U.N. model, the proposed treaty specifically provides that no deduction is allowed with respect to amounts (other than reimbursements for actual expenses) paid by the permanent establishment to its home office or to any of its other offices as royalties, fees, etc.; in return for the use of patents or other rights; or as a commission for specific services performed or for management; or as interest on moneys lent to the permanent establishment. The proposed treaty also provides a reciprocal rule so that no consideration is given to the same types of payments made by the home office to the permanent establishment.

(12) The proposed treaty does not contain the usual treaty provision stating that the treaty is not intended to limit any law of either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related persons if such law is necessary to prevent evasion of taxes or to clearly reflect the income of such persons. This provision generally serves as clarification that the United States retains the right to apply its intercompany pricing rules (Code sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and applicable regulations). Notwithstanding the omission of the standard provision, it is understood that the United States retains the right under the proposed treaty to apply its internal law intercompany pricing and expense allocation rules.

(13) The proposed treaty's limits on gross-basis dividend withholding taxes that the country of source may impose on dividends received by a resident of the other country differ from those of the U.S. model. Both treaties provide for two levels of limitation. With respect to the proposed treaty, these levels are 14 percent in the case of dividends paid to a 25-percent or more corporate owner, and 20 percent in other cases. These limitations contrast with the 5-percent limit on dividends paid to 10-percent or more corporate owners and the 15-percent limit on other dividends contained in the U.S. model.

Additionally, the proposed treaty sets forth special rules with respect to the application of the article on dividends to distributions by U.S. regulated investment companies (RICs) and real estate investment trusts (REITs). In the case of any dividends paid by a RIC to a corporation, a 20-percent gross basis withholding tax will apply, notwithstanding the level of ownership of the shareholder.

In the case of dividends from a REIT, a 20-percent gross basis withholding tax rate applies if the recipient of the dividends is an individual holding a less than 25-percent interest in the trust. In other cases, the rate of withholding tax applicable, under domestic law, to the underlying income of the REIT will apply (i.e., 30 percent).

(14) Generally, the proposed treaty, the U.S. model, and the OECD model all share a common definition of the term "dividends." [3] The proposed treaty further defines this term to include income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the local law of the country in which the income arises.

(15) The proposed treaty generally allows imposition by one country of branch-level profits and interest taxes on corporations resident in the other country.

(16) The proposed treaty generally limits the rate of withholding tax at source on gross interest to 15 percent. As an exception to this general rule, interest is exempt from source-country taxation if it is derived by the governments of the countries, derived by financial institutions on certain long-term loans (i.e., obligations having maturities of seven years or more), or paid by the Tunisian Government to a U.S. resident in connection with loans extended to the Tunisian Government or its political subdivisions or local authorities. Under the U.S. model, all interest generally is exempt from source country withholding tax. The OECD model permits source-country taxation of dividends at a rate of up to 10 percent.

As a result of the repeal, in the Tax Reform Act of 1984 (the "1984 Act"), of the U.S. gross withholding tax on interest paid on portfolio indebtedness held by foreign persons, Tunisian residents generally are able to earn U.S. source interest on portfolio indebtedness free of U.S. tax, without regard to benefits provided by a treaty. U.S. residents, on the other hand, generally are subject to Tunisian tax on Tunisian source interest on similar indebtedness (limited to a rate of 15 percent by the treaty).

(17) The proposed treaty allows source-country taxation of royalties at rates ranging from 10 to 15 percent. Both the U.S. and OECD models exempt royalties from source-country tax.

The proposed treaty includes in the definition of royalties, payments of any kind received in consideration for the use of, or the right to use, industrial, commercial, or scientific equipment. Such payments are not treated as royalties under the U.S. model, although they are so treated under the OECD model. Rather, they generally are subject, under the U.S. model, to the provisions of the business profits article of that treaty (Article 7).

(18) The proposed treaty permits source-country taxation of income derived from the performance of independent personal services by an individual resident of the other country on the basis of that individual's physical presence in the source country for more than 183 days during any taxable year. The proposed treaty also permits source-country taxation of income derived from the per-

[3] That definition is "income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."

formance of independent personal services by such a person if the gross amount of such income for any taxable year exceeds $7,500. Neither the U.S. model nor the OECD model allow taxation of such income on the basis of days of physical presence; nor do they allow such taxation on the ground that the amount of income derived exceeds a threshold level. Under the models, income derived from the performance of independent personal services by a nonresident is taxable in the source country only if that person earns the income through a fixed base in that country.

(19) Under the proposed treaty, a source country may tax income derived by an entertainer or athlete who is a resident of the other country from his or her activity as such if the amount of gross receipts from the source country exceeds $7,500 in a taxable year. Under the U.S. model treaty, an entertainer or athlete is so taxable in the source country only if he or she earns more than $20,000 there during a taxable year. Most U.S. income tax treaties follow the U.S. model rule, but adopt a lower annual income threshold. Under the OECD model, entertainers and athletes may be taxed by the source country without regard to the existence of a fixed base or other contacts with the source country, regardless of the amount of income that they earn from artistic or athletic endeavors.

(20) Under the U.S. model, the United States maintains the exclusive rights to tax U.S. social security payments made to residents of the other country or to U.S. citizens. By contrast, the proposed treaty permits both the U.S. and Tunisia to tax social security payments. In cases where both countries tax such payments, the recipient's country of residence is required to provide relief from double taxation for any taxes imposed by the other country.

(21) The proposed treaty prohibits either country from taxing the recipient of child support payments. This result follows from U.S. law, which provides that such payments are not taxable to the recipient. The U.S. model allows only the country of residence of the payor to tax such payments.

(22) The proposed treaty generally permits a pension paid out of public funds of one of the countries to an individual who is a resident of the other country for past services rendered in the discharge of governmental functions to be taxed only by the individual's country of residence. If the individual is a citizen of the paying country, however, that country may also tax the payments. This provision represents a departure from the U.S. model provision that permits the paying country to tax any such payment made to a resident of the other country.

(23) The exemption from host country taxation provided in the proposed treaty to visiting students and trainees differs from the corresponding exemptions provided in the U.S. model. The model exemptions apply only to payments received from outside the host country for maintenance, education, study, research, or training. The proposed treaty exemption extends to, among other things, $4,000 per year of personal services income in the case of a student. The proposed treaty limits the period during which the exemption applies to five years, whereas the U.S. model does not set forth any time limit for this purpose.

(24) Both the proposed treaty and the U.S. model contain provisions that prohibit a country (the "taxing country") from subjecting certain persons to any taxation or related requirement that is more burdensome than the taxation and related requirements to which its nationals are subjected. For purposes of the U.S. model, this provision applies to any national of the other country. By contrast, application of the corresponding rule in the proposed treaty is limited to nationals of the other country who are resident in the taxing country.

(25) The anti-treaty shopping provisions of the proposed treaty resemble, to some extent, those of the U.S. model. Certain differences exist between the two provisions, however. For example, the U.S. model requires more than 75 percent of the beneficial interest of a non-public company that is resident in one of the countries to be owned by individual residents of that country in order to qualify for treaty benefits. The proposed treaty reduces the ownership threshold to 50 percent. Furthermore, those who must own the threshold percentage include not only individual residents of the country in which the company is resident, but also individual residents of the other country, U.S. citizens, and the governments of the two countries. Similar 50-percent thresholds are also contained in the anti-treaty shopping provisions of Code section 884(e)(4) (relating to the branch-level profits and interest taxes), as well as in other recent treaties.

The U.S. model contains two special rules related to treaty shopping, neither of which is included in the proposed treaty. Under the first special rule, the general rules limiting treaty benefits do not apply if it is determined that the principal purpose behind the acquisition or maintenance of an entity and the conduct of its operations was not to obtain treaty benefits. Under the second special rule, the U.S. model specifies that no treaty relief is granted by one country to a resident of the other country if, under the domestic law of that other country, the income to which the relief relates bears significantly lower tax than similar income arising in the other country derived by residents of the other country.

Under the proposed treaty, a country is required to consult with the competent authority of the other country prior to denying treaty benefits to a resident of the other country. It is understood that this rule does not impose a requirement that there be an agreement between the two competent authorities before benefits can be denied. Rather, this rule is designed to facilitate notification of such a denial by one of the competent authorities to the other. Furthermore, a special rule contained in the proposed treaty permits a person to whom treaty benefits are denied under the general rules to nevertheless be granted those benefits if so determined by the competent authority of the country in which the relevant income arises.

(26) The U.S. model provides for the exchange of information relating to taxes of every kind imposed by the two countries. By contrast, the proposed treaty provides for the exchange of information only as it is relevant to the assessment of taxes covered by the treaty. The U.S. model requires that, upon an appropriate request for information, the requested country provide the information in the form requested. Although the proposed treaty requires a re-

quested competent authority to obtain the information so requested, there is no requirement that the information be obtained and transmitted in any specific manner or form. Also unlike the U.S. model treaty (but like the OECD model), the proposed treaty does not obligate either country to endeavor to collect, on behalf of the other country, such amounts as may be necessary to ensure that relief granted by the treaty from tax imposed by the other country does not inure to the benefit of persons not entitled thereto.

II. ISSUES

The proposed treaty, as amended by the proposed protocol, presents the following specific issues.

(1) U.S. tax on certain stock gains of foreign persons

The United States does not currently impose tax on U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate. The proposed treaty provides that gains of Tunisian residents are exempt from U.S. tax unless they are (1) gains from the disposition of U.S. real property interests; (2) gains from the alienation of personal property which forms or formed part of the business property of a permanent establishment or a fixed base in the United States; or (3) gains from the alienation of a right or property which are contingent on the productivity, use, or disposition thereof. Thus, if a Tunisian resident, without a U.S. permanent establishment or fixed base, owns stock in a U.S. corporation, any gains from the disposition of that stock generally will be exempt from U.S. tax under the treaty, whether or not U.S. internal law is changed to provide for such a tax, unless that change is intended to override existing treaties.

In 1989 the House of Representatives passed a bill that would have taxed the gain on a disposition by a foreign person of stock in a U.S. corporation if the foreign person holds or held more than 10 percent of the stock of the U.S. corporation at any time during the 5 years prior to the disposition.[4] This provision, had it been enacted into law, would have yielded to contrary existing treaties for a 3-year period and then overridden them subsequently. In the committee report on this provision, however, it was anticipated that in some cases, it could have been desirable for the United States to enter into treaties that would modify the effect of the provision on treaty country residents.

The override provision was considered by the Administration to be a serious defect in the bill, putting aside the more basic tax policy question whether such gains of foreign persons should be exempt in all cases from U.S. tax, when dividends paid by U.S. corporations to foreign persons are not, or whether or not it would be more appropriate to tax gains no more favorably than dividends.

Bills have been introduced this year in both Houses of Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person holds or held at least 10 percent of

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[4] H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989). The provision was deleted in conference.

the stock of the domestic corporation.[5] Unlike the unsuccessful House bill provision of 1989, the 1990 bills generally do not override existing contrary treaties. The proposed treaty would thus prevent the operation of the bill vis-a-vis Tunisian residents if the bill is passed.

The issue is whether it is advisable to enter into a treaty that forbids a tax that the Congress may decide to impose as the result of a change in its internal tax law policy. Although prior Congresses may have believed that the gains realized by foreign persons from the disposition of stock in U.S. companies were properly excluded, as a statutory matter, from the U.S. tax base, whether for reasons of administrability or for other reasons, Congress may decide that it is no longer appropriate to do so in the case of substantial foreign shareholders in U.S. stock. The Congress could further decide that, just as it is inappropriate in treaties to reduce source-country taxation of dividends to zero, it is similarly inappropriate to reduce to zero the rate of tax on gains from stock that pays such dividends, or that it is inappropriate to reduce such tax to zero in all cases and for all types of dispositions.

Alternatively, the Congress could decide that, while a tax on stock gains should be imposed by statute, it may properly be waived in treaties, or at least treaties with countries that, in Congress's view, impose an adequate level of tax on the types of stock gains of its residents that would otherwise be subject to tax under the statute. As reflected in the OECD model and many existing treaties, for example, countries that do impose tax on the stock gains of foreign persons often waive such taxes in treaties, although because of differences in definitions of the term "gains" in other countries, those treaties may not operate in precisely the same manner as a U.S. income tax treaty, using U.S. definitions of the term "gain," would operate. (The U.S. model treaty also provides for waiver of the tax, but the U.S. model was last revised at a time when such a waiver would not have reduced any U.S. tax otherwise imposed by the Code, and thus could only have reduced foreign country taxes.)

It is understood that Tunisia does not currently impose a tax on stock gains of foreign persons. Thus, prohibition of that tax in the proposed treaty may not be viewed as a benefit to U.S. taxpayers (or the U.S. fisc) at the expense of the Tunisian fisc. However, if both countries were to at some point in the future impose such a tax, then some may argue that such a prohibition would most likely represent a benefit to U.S. taxpayers (or the U.S. fisc), in light of the balance of investment flows between the two countries. If the Senate agrees to a treaty with Tunisia, and then Congress enacts the stock gains tax that the treaty protects Tunisian residents from paying, it is unclear whether, in subsequent treaty negotiations, the United States and Tunisia would agree to retention or removal of the treaty restriction on each country's tax on stock gains of foreign persons. Consideration might be given, by both parties to the treaty, to questions such as whether Tunisia at that time imposed a similar tax under its internal law and how the im-

[5] H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess. (1990).

position or elimination of such a tax by the United States (and by Tunisia, if applicable) is likely to affect the taxation by Tunisia of U.S. residents, as well as the taxation by the United States of Tunisian residents.

The Committee might address this issue in alternative ways. First, the Committee might recommend that the Senate consent to the treaty notwithstanding this issue. It is not clear if or when Congress will enact a tax on foreign persons' stock gains; if Congress does not do so, then there will have been no need for the Committee to take notice of this issue. In addition, the Committee might conclude that the waiver contained in the proposed treaty is in the best interests of the United States.

Alternatively, if the Committee believed that it should preserve the right, in whole or in part, to tax Tunisian's U.S. stock gains and that Tunisia should be free to tax, in whole or in part, U.S. persons' Tunisian stock gains, the Committee could seek a reservation allowing the United States to impose a tax on stock gains at a rate no less than that imposed on dividends, to limit the amount by which the tax on stock gains could be reduced, or to limit the cases in which it could be eliminated. This course, while it could allow the United States to collect the tax (if enacted), could also present a condition that the Tunisian Government finds unacceptable. Therefore, this course could delay or prevent the benefits of the treaty.

Third, the Committee could delay action on the treaty while it awaits legislative progress on the pending bills. This course would delay the time when taxpayers will know if and whether the rules of the proposed treaty will apply to their transactions.

(2) Developing country concessions

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. Some of these concessions are listed below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD model treaties by providing for relatively broad source-basis taxation. The proposed treaty's permanent establishment article, for example, permits the country in which business activities are carried on by a resident of the other country to tax the activities sooner, in certain cases, than it would be able to under either of the model treaties. Under the proposed treaty, a building site or construction, assembly, or installation project (or supervisory activities related to such projects) creates a permanent establishment if it exists in a country for more than 183 days in any 365-day period; under the U.S. model, a building site, etc., must last for at least one year before a permanent establishment is created. Thus, for example, under the proposed treaty, business profits attributable to an installation project in Tunisia are taxable by Tunisia if the project lasts for more than 183 days during a 365-day period. Similarly, under the proposed treaty, the use of a drilling rig in Tunisia for more than 183 days during a 365-day period creates a permanent establishment there; under the U.S. model, drilling rigs must be present in

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a country for at least one year to have the same effect. The 183-day period set forth in the proposed treaty is also utilized in tax treaties between the United States and other developing countries.

In addition, the proposed treaty contains a special provision that treats an insurance company that is resident in one of the countries as having a permanent establishment in the other country in certain cases if it receives premiums from, or insures risks in, that other country. This rule applies unless the risks are insured through a broker or independent agent operating in the ordinary course of his or her business. Under this rule, for example, if a U.S. insurance company, through an employee, insures risks located in Tunisia, then the income generated from the insurance of those risks may be taxed by Tunisia under the business profits article of the proposed treaty. A similar provision is found in the United Nations' model treaty.

Source-basis taxation

Concessions to source-basis taxation in the proposed treaty include maximum rates of source-country tax on interest (15 percent, subject to certain exceptions providing for complete exemption), dividends (14 percent for direct investors, 20 percent for other shareholders), and royalties (either 10 or 15 percent depending on the nature of the royalty) that are higher than those provided in the U.S. model treaty, but which, in some cases, represent reductions from the tax that would be imposed by Tunisia on these types of income absent a treaty. Also, the proposed treaty provides for broader source-country taxation of independent personal services income and entertainers' income than is allowed by the U.S. model.

Certain equipment leasing

In addition to containing the traditional definition of royalties which is found in most U.S. tax treaties (including the U.S. model), the proposed treaty provides that royalties include payments for the use of, or the right to use, industrial, commercial, or scientific equipment. These payments are often considered rentals in treaties with other industrialized countries, subject to business profits rules which generally permit the source country to tax such profits only if they are attributable to a permanent establishment located in that country. In such case, the tax is computed on a net basis. By contrast, the proposed treaty permits gross-basis source-country taxation of these payments, at a rate not to exceed 10 percent, if the payments are not attributable to a permanent establishment situated in that country.[6]

Taxation of public pensions

Under the U.S. and OECD model treaties, pensions paid to persons out of the public funds of a treaty country (or of its political subdivisions or local authorities) with respect to services rendered in the discharge of functions of a governmental nature may be taxed by that country. Thus, for example, if the Government of United States were to make pension payments to a resident of the

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[6] If the payments are attributable to such a permanent establishment, then the business profits article of the proposed treaty applies.

other treaty country, those payments could be taxed by the United States. By contrast, the proposed treaty prohibits the paying country from taxing similar payments made to residents of the other country, unless the recipient of the payments is a citizen of the paying country. Therefore, in a situation similar to that described above, the United States would be precluded by the proposed treaty from taxing governmental pension payments made to a resident of Tunisia, unless that person was a U.S. citizen.

Issue presented

One purpose of the proposed treaty is to facilitate direct investment by U.S. firms in Tunisia by eliminating tax barriers, thereby enhancing a free flow of capital between the two countries. The practical effect of these developing country concessions could be greater Tunisian taxation of future activities of U.S. firms in Tunisia than would be the case under the rules of either the U.S. or OECD model treaties.

The issue is whether these developing country concessions are appropriate U.S. treaty policy and, if so, whether Tunisia is an appropriate recipient of these concessions. There is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with other developing countries. A number of existing U.S. treaties with developing countries already include developing country concessions, however. Concessions of this nature are arguably necessary in order to obtain treaties with developing countries such as Tunisia. Tax treaties with developing countries can be in the interest of the United States because they provide developing country tax relief for U.S. investors and a clearer framework within which the taxation of U.S. investors will take place.

(3) Treaty shopping

The proposed treaty, like a number of existing U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Tunisia and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax on interest by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country, which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) an in several newer treaties, including the treaties that are the subject of this hearing.

Some aspects of the provision, however, differ either from the corresponding provision of the U.S. model or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. An issue, then, is whether the proposed treaty's anti-treaty shopping provisions effectively forestall potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the U.S. model and other U.S. treaties. The U.S. model denies benefits if 75 percent or less of a resident company's stock is held by individual residents of the company's country of residence, while the proposed treaty (like several recent treaties and an anti-treaty shopping provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country, citizens of the United States, and the governments of the two treaty countries. Thus, this safe harbor is considerably easier to enter, under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country does not appear to invite the type of abuse at which the provision is aimed; that is, ownership by third-country residents attempting to obtain unwarranted treaty benefits. In addition, a base erosion test contained in the proposed treaty provides protection from many potential abuses of a Tunisian conduit.

Another provision of the anti-treaty shopping article differs from the comparable rule of the U.S. model, but the effect of the change is less clear. The general test applied by the U.S. model to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with (or incidental to) the active conduct of a trade or business. (However, this active trade or business test generally does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty gives the competent authorities the ability to override this standard.

The practical difference between the proposed treaty tests and the U.S. model test will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty test (i.e., would operate to deny benefits in potentially abusive situations more often).

The United States should maintain its policy of limiting treaty shopping opportunities whenever possible, and in exercising any latitude Treasury has to adjust the operation of the proposed

treaty, it should satisfy itself that its rules adequately deter treaty shopping abuses. The provision contained in the proposed treaty may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Tunisia since those investors may be unwilling to share ownership of such investing entities on an equal basis with U.S. or Tunisian residents in order to meet the ownership test.

(4) Exchange of information

The exchange of information article contained in the proposed treaty differs, in some respects, from the corresponding articles of the OECD and U.S. model treaties. The exchange of information article of the U.S. model, as compared to that article in the OECD model (and in the proposed treaty) provides for a somewhat broader scope of information exchange. For example, although the U.S. model and the proposed treaty contain a provision not found in the OECD model, that places a requirement on the competent authority of a treaty country to obtain the information requested by the other competent authority "in the same manner and to the same extent" as if the tax of the requesting country was its own tax and was being imposed by it, the U.S. model provision goes further than do the proposed treaty or the OECD model by providing an additional information-exchange requirement. The provision of the U.S. model places a requirement on each treaty country, if specifically requested by the other country, to provide information in the form of depositions of witnesses and authenticated copies of unedited original documents, including books, papers, statements, records, accounts, or writings, to the same extent that such depositions and documents are obtainable under its internal laws and administrative practices and procedures with respect to its own taxes. This part of the U.S. model's exchange of information article is intended to assure that evidence can be obtained in a form admissible for purposes of litigation.

A second difference between the U.S model and the proposed treaty (and OECD model) is that the U.S. model contains a clause that requires each treaty country to assist in the collection of taxes to the extent necessary to ensure that treaty benefits provided by the other country are enjoyed only by persons entitled to those benefits under the treaty. In providing such assistance, the U.S. model does not impose on the other country an obligation to carry out administrative measures that are at variance with its internal measures for tax collection, or that are contrary to its sovereignty, security, or public policy. Assistance in collection can be useful, for example, in a case where an entity located in a country with which the United States has a treaty serves as a nominee for a third-country resident. If the entity, on behalf of the third-country resident, receives a dividend from a U.S. corporation with respect to which a reduced rate of tax (as provided for by the treaty) is inappropriately withheld, the entity, as a withholding agent, is technically liable to the United States for the underpaid amount of tax. However, without assistance from the government of the treaty country in which the entity is resident, enforcement of that liability may be difficult.

A third item which causes the U.S. model's exchange of information provisions to be more expansive than the corresponding provisions of the other two treaties is that the model's provisions are made specifically applicable to taxes of every kind imposed at the national level, notwithstanding the limitations contained in the taxes covered article of the treaty. A provision of this type permits, for example, information exchanges regarding estate taxes even though general application of the treaty provision do not cover those taxes.

The issue is whether the Committee views the exchange of information and collection assistance rules contained in the proposed treaty as sufficient to carry out the tax-avoidance purpose for which income tax treaties are entered into by the United States. With respect to the form of the information provided, it will be preferable for the United States to be able to obtain information from Tunisia in the forms specified in the U.S. model treaty. The proposed treaty does require Tunisia, however, to obtain information requested by the United States in the same manner and to the same extent as if the U.S. tax at issue were Tunisian tax. Thus, the proposed treaty may provide some assurance that Tunisia will take whatever measures are possible under its tax laws to obtain information for the benefit of the United States.

With respect to the absence of a reciprocal tax collection provision, the Committee may wish to consider the extent to which absence of such a provision adversely affects U.S. efforts to confine Tunisian treaty benefits to persons entitled to those benefits. Absence of collection assistance in this treaty also may decrease the United States's ability to obtain the desired level of collection assistance in treaty negotiations with other countries.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income that are effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level interest tax, which amounts to a flat 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien or foreign corporation (including generally interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is one or four percent of the premium paid. The gross-basis tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

These taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has

an income tax treaty. In addition, certain statutory exemptions from the 30-percent tax are provided. For example, interest on deposits with banks or savings institutions is exempt from tax unless such interest is effectively connected with the conduct of a U.S. trade or business. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio obligations is exempt from the 30-percent tax. Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that the corporation's net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited, however, by the amount of tax-exempt interest paid to related persons.

U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real property.[7]

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, then interest paid by that corporation is foreign source rather than U.S. source income. Moreover, even though dividends paid by a corporation meeting this test are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to withholding tax. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend is considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be

[7] In addition, bills have been introduced in Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person held at least a threshold amount (i.e., 10 percent) of the stock of the domestic corporation (H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess., (1990)).

either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises, and other like property).

Double taxation of income can arise under the U.S. tax system, because income earned abroad by a U.S. person may be taxed both by the country in which the income is earned and by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Pursuant to rules enacted as part of the Tax Reform Act of 1986 (the "1986 Act"), the overall limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of foreign source income traditionally subject to high foreign taxes against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Prior to the 1984 Act, a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply only to 50-percent U.S.-owned foreign corporations. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided look-through rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic taxable income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, as amended by the Omnibus Budget Reconciliation Act of 1989, no such limitation is imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and re-

ceives a dividend from the foreign corporation is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. These taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited, subject to the various separate income limitations and the overall limitation.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation generally is accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by re-

quiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally is not subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent tax and seeks to reduce or eliminate this tax in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can also still arise because most countries do not exempt passive income from tax at the source. This double taxation is mitigated either by granting a credit for income taxes paid to the other country or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty

partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further assured under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries without income tax treaties with the United States attempt to use a treaty to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

Tax treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that which it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

Set forth below is a detailed, article-by-article explanation of the proposed income tax treaty and, where applicable, the proposed protocol between the United States and Tunisia.

Article 1. Personal Scope

As a general rule, the proposed treaty applies to residents of the United States or Tunisia or of both countries. For purposes of the proposed treaty, the definition of a resident of the United States or Tunisia is set forth in the article on fiscal domicile (Article 4). There are certain exceptions to the general application of the proposed treaty to residents of the United States or Tunisia. For example, the article dealing with general rules of taxation (Article 22) provides, among other things, that either country reserves the right to tax its citizens (and in certain cases former citizens) or residents in accordance with its domestic laws as if the proposed treaty was not in effect. In addition, other provisions of the proposed treaty, such as provisions related to exchange of information and administrative assistance (Article 26) and the source rule for interest payments (Article 11(6)), may apply to persons not specified in Article 1.

Article 2. Taxes Covered

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed under the Code. It does not apply, however, to the accumulated earnings tax, the personal holding company tax, or social security taxes. In addition, the proposed treaty generally does not apply to non-income taxes such as excise,[8] unemployment, estate, or gift taxes. Likewise, state and local taxes are not covered by the proposed treaty.

In the case of Tunisia, the treaty applies to the following taxes: the tax on industrial and commercial profits; the tax on corporations; the tax on capital gains on real property; the tax on profits of non-commercial professions; the tax on wages, salaries, and pensions; the agricultural tax; the tax on dividends; the tax on income from credits, deposits, guarantees and current accounts; the personal income tax; and the extraordinary tax for national solidarity.

The proposed treaty contains a provision generally found in U.S. income tax treaties to the effect that it also will apply to any identical or substantially similar taxes that either country may subsequently impose.

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[8] The excise tax imposed on insurance premiums paid to foreign insurers is not covered under the proposed treaty, although this is a covered tax under the U.S. model treaty, as well as under some recent U.S. income tax treaties. The preferred U.S. treaty position for some countries does not include coverage of this excise tax.

Additionally, the non-discrimination provisions of the proposed treaty (Article 24) apply to all taxes of every kind imposed at the national, state, or local level by the United States or Tunisia.

Article 3. General Definitions

The proposed treaty contains some of the standard definitions found in most U.S. income tax treaties.

The term "person" is defined to include an individual, a company, an estate, a trust, or any other body of persons. A partnership is included in this definition under the phrase "any other body of persons."

The term "company" means any corporation or any entity that is treated as a corporation for tax purposes.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting States" mean, respectively, an enterprise carried on by a resident of one of the treaty countries and an enterprise carried on by a resident of the other treaty country.

The U.S. competent authority is the Secretary of the Treasury or his authorized representative. The U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International). On interpretive issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

The Tunisian competent authority is the Minister of Finance, or his authorized representative.

For purposes of the proposed treaty, the "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used in a geographical sense, the term includes the fifty States, the District of Columbia, the territorial waters of the United States, and any area which, in accordance with international law, is an area within which the rights of the United States with respect to the natural resources of the seabed and subsoil may be exercised. The definition is intended to cover the U.S. continental shelf consistent with the definition of continental shelf contained in section 638 of the Code.

The term "Tunisia" means the Republic of Tunisia. The term also includes, when used in a geographical sense, the territorial waters of Tunisia and any area outside Tunisia which, in accordance with international law, is an area within which the rights of Tunisia with respect to the natural resources of the seabed and subsoil may be exercised.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft, except where the transport is solely between places in one of the treaty countries. Accordingly, with respect to a Tunisian enterprise, purely domestic transport in the United States is excluded from this definition.

The proposed treaty provides that any term which it does not define is to have the meaning it has under the applicable law of the country applying the proposed treaty, unless the context otherwise requires. If the meaning of an undefined term under one country's law is different from its meaning under the other country's law, or is not readily determinable under either country's law, the

competent authorities of the two countries may establish a common meaning for the undefined term.

Article 4. Fiscal Domicile

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a "resident" of one of the countries as that term is defined by the proposed treaty. Furthermore, double taxation is often avoided by the proposed treaty assigning one of the countries as the country of residence where, under the laws of the countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his or her worldwide income, whereas a nonresident alien is taxed only on U.S. source income and on income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. Under the standards for determining residence provided under U.S. law, an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes also is a U.S. resident. The standards for determining residence provided under U.S. law do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States).

Under the proposed treaty, the term "resident of a Contracting State" means the governments of the United States and Tunisia (or any political subdivision or local authority of either), or any person who under the laws of either the United States or Tunisia is subject to tax in that country by reason of his or her domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. It is understood that a partnership is considered a resident of either country only to the extent that the income it derives is subject to tax as the income of a resident of the country. For example, if the share of Tunisian partners in the income of a partnership is only one-half, the United States would have to reduce its withholding tax on only one-half of the U.S. source income paid to the partnership.

Under this article of the proposed treaty, U.S. citizenship alone does not establish U.S. residency for treaty purposes. As a result, U.S. citizens residing overseas (in countries other than Tunisia) generally are not entitled to the benefits of the proposed treaty as U.S. residents. Only in very few U.S. income tax treaties has the United States negotiated coverage for nonresident U.S. citizens. The proposed treaty also extends this limitation to aliens admitted to the United States for permanent residence who do not have a substantial presence, permanent home, or habitual abode in the United States.

The fiscal domicile article also provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the basic residence rules, is considered a resident of both the United States and Tunisia. These rules are similar to those contained in the U.S. model treaty. In the case of a dual resident individual, the individual is deemed for all purposes of the proposed

treaty to be a resident only of the country in which the individual has his or her permanent home (that is, the place where an individual dwells with his or her family), the center of his or her vital interests (i.e., his or her closest economic and personal relations), his or her habitual abode, or his or her citizenship. If the residence of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the two countries are to settle the question of residence by mutual agreement.

In the case of a dual residence person other than an individual, the proposed treaty requires the competent authorities of the two countries to endeavor to settle the question by mutual agreement and to determine how the proposed treaty applies to that person. Dual residency may occur, for example, in the case of a corporation as a result of the differing standards for determining residency under the domestic laws of the United States and Tunisia. Under U.S. law, a corporation is considered a resident of the United States if it is organized or incorporated under the laws of the United States or of any State. By contrast, Tunisia treats any corporation, wherever organized or incorporated, as a resident of Tunisia if its place of effective management is in Tunisia. Staff is informed that the U.S. competent authority has never agreed to treat a U.S.-incorporated company as a nonresident of the United States for treaty purposes, and as a matter of policy never would so agree.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that, subject to certain modifications, generally follows the pattern of other recent U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in that other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those amounts are taxed as business profits.

In general terms, under the proposed treaty, a permanent establishment is a fixed place of business through which a resident of one country engages in business in the other country. A permanent establishment includes (but is not limited to) a place of management, branch, office, factory, workshop, or a mine, oil or gas well, quarry, or other place of extraction of natural resources. A permanent establishment also includes a building site, construction, assembly, or installation project, or an installation, drilling rig, or ship used for the exploration or exploitation of natural resources, or related supervisory activities, but only if the site, project, drilling rig, etc. lasts for more than 183 days in any 365-day period. This 183-day rule differs from the 12-month rule of the U.S. model.

The general permanent establishment rule is modified to provide that a fixed place of business in one country which is only used by a resident of the other country for any or all of a number of speci-

fied activities does not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the resident; the maintenance of a stock of goods belonging to the resident solely for the purpose of storage, display, delivery, or processing by another person; and the maintenance of a fixed place of business solely to purchase goods or merchandise, to collect information, or to carry on any other activity of a preparatory or auxiliary character (e.g., advertising, supplying information, or scientific research), for the resident. In addition, the maintenance of a fixed place of business solely for any combination of the activities listed in this paragraph does not constitute a permanent establishment as long as the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

If a resident of one country maintains an agent in the other country who has, and habitually exercises, the authority to conclude contracts in that other country in the name of the resident, then the resident generally is deemed to have a permanent establishment in that other country. This rule does not apply where the contracting authority is limited to those activities, such as storage, display, or delivery of merchandise (as described in the preceding paragraph) that are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule does not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of his or her business.

The fact that a company which is a resident of one country controls, or is controlled by, a company which is a resident of the other country or which is engaged in business in that other country (whether through a permanent establishment or otherwise) does not in and of itself constitute either company a permanent establishment of the other.

The proposed treaty provides a special rule for the determination of the existence of a permanent establishment in the case of companies engaged in insurance activities. Generally, if an insurance company that is a resident of one of the countries earns premiums from, or insures risks in, the other country, then it is considered to have a permanent establishment in that other country. This rule does not apply, however, if the insurance is placed through a broker or agent of independent status acting in the ordinary course of his or her business.

Article 6. Income from Real Property

The proposed treaty provides that income from real property, including income from the leasing or use in any form of real property and income from agriculture or forestry, may be taxed by the country in which the real property or natural resources are situated. Additional rules regarding the taxation of dispositions of real property are provided in the article on capital gains (Article 13).

The term "real property" has the meaning which it has under the law of the country in which the property in question is located. The term in any case includes property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property

apply, usufruct of immovable property, and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats, and aircraft are not real property.

Interest on indebtedness secured by real property or secured by a right giving rise to income from the exploitation of natural resources is not regarded as income from real property. Such amounts are subject to the provisions of the article on interest (Article 11).

Although an election to compute tax on income from real property on a net basis is often included in U.S. tax treaties (and is included in the U.S. model treaty), no such election is provided for in the proposed treaty. It is understood that the internal laws of both the United States and Tunisia generally provide for net-basis taxation of such income, however.

Real property income may also be taxed by the taxpayer's country of residence. In such a case, residence-country taxation is subject to relief from double taxation (Article 23).

Article 7. Business Profits

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate tax rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business are a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

In the case of foreign persons other than insurance companies, foreign source income is treated as effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For such persons, only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends and interest, derived in the active conduct of a banking, financing, or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as such income is attributable to its United States business. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its world-wide operations and by the U.S. insurance industry.

Except in the case of a dealer, trading in stocks, securities, or commodities in the United States for one's own account does not constitute a trade or business in the United States and, accordingly, income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent or trading by a foreign person physically present in the United States.

The Code, as amended by the 1986 Act, provides that any income or gain of a foreign person for any taxable year that is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty rules

Under the proposed treaty, business profits of a resident of one country are taxable in the other country (the "source country") only to the extent that they are attributable to a permanent establishment in the source country through which the resident carries on business activity. This is one of the basic limitations on a source country's right to tax income of a resident of the other country.

The proposed protocol contains a provision that is relevant to the rules contained in this article, as well as in the articles on dividends (Article 10), interest (Article 11), royalties (Article 12), capital gains (Article 13), independent personal services (Article 14), and other income (Article 21). That provision, which is consistent with Code section 864(c)(6), states that for the implementation of those articles, profits and income attributable to a permanent establishment or fixed base during its existence is taxable in the country in which the permanent establishment or fixed base is located, even if the payments of such profits and income are deferred until the permanent establishment or fixed base has ceased to exist.

The taxation of business profits under the proposed treaty differs from the U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

Business profits of a permanent establishment generated from transactions with related persons are determined on an arm's-length basis. Thus, there are to be attributed to a permanent establishment the business profits that would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions. For example, this arm's-length rule applies to transactions between a permanent establishment and an office of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses reasonably connected with the profits, wherever incurred. These deductions include a reasonable allocation of executive and general administrative expenses. Thus, for example, a U.S. company that has a branch office in Tunisia and its head office in the United States is, in computing the Tunisian tax liability of the branch, entitled to deduct a portion of the executive and general administrative expenses incurred in the United States by the head office for purposes of administering the branch. No such deduction is allowed, however, in respect of amounts paid (other than as reimbursements of actual expenses) by the permanent establishment to the head office (or any other of its offices) as royalties, fees or other similar payments as consideration for the use of patents or other rights, or as commissions for specific services performed or for management, or as interest on moneys lent to the permanent establishment. A reciprocal rule applies for specified payments from the head office (or other office) to the permanent establishment.

In addition, no profits will be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment for the account of the resident of which it is a permanent establishment. Thus, where a permanent establishment purchases goods for its head office, the profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element on its purchasing activities.

According to the proposed treaty, the method of determining profits attributable to a permanent establishment is to be applied consistently from year to year, unless there is sufficient reason for using an inconsistent method.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other

articles, and not Article 7, generally govern the treatment of those items of income.

The proposed treaty provides that a partner's share of the income of a partnership is taxable in the country where the partnership has a permanent establishment.

Finally, the proposed treaty contains a provision designed to permit the tax authorities of either the United States or Tunisia to apply the provisions of the respective country's internal law in determining tax liability in cases where the information available to the competent authority is inadequate to accurately compute the profits of a permanent establishment. Such a determination must be done in a manner which reflects arm's-length pricing and appropriate deductions in accordance with the principles of Article 7. The Internal Revenue Service has this authority notwithstanding this special provision.

Article 8. Shipping and Air Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing reciprocal tax exemptions for shipping and aircraft income.

Under the proposed treaty, the rights of the two countries to tax income that is derived from the operation of ships or aircraft in international traffic is limited to certain cases. Tunisia is permitted to tax such income only if the place of effective management of the enterprise is in Tunisia, or is aboard a ship whose home harbor is Tunisia or whose operator is a resident of Tunisia. The United States is permitted to tax this income only if the enterprise is created under the laws of the United States or any State. In effect, each country is permitted to tax income from international shipping or air transport only if the enterprise is a resident of that country for domestic tax purposes. Both countries are permitted to tax such income of a dual resident country, subject to the provisions of the article providing relief from double taxation (Article 23).

These rules also apply to profits derived from the participation in a pool, joint business, or international operating agency.

Article 8 takes precedence over the article on business profits (Article 7). Thus, each country is required to exempt the shipping income of a resident of the other country, even if the income is attributable to a permanent establishment in the first country.

International traffic is any transportation by ship or aircraft, except where the transportation is solely between places in one of the countries (Article 3(1)(g) (General Definitions)).

Profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft, if operated in international traffic by the lessee or if such rental profits are occasional and accessory to the actual operation of ships or aircraft in international traffic. In addition, those profits include

income derived from the use, maintenance, or rental of containers, or other related equipment where the containers, equipment, etc. are used in international traffic, if such income is occasional and accessory to the actual operation of ships or aircraft in international traffic. Income derived from container leasing by companies not engaged in international shipping or air transport is covered by the article on business profits (Article 7) or independent personal services (Article 14), as appropriate. Thus, source-country taxation of container leasing income is permitted only if the income is attributable to a permanent establishment or a fixed base in the source country.

Rules similar to the rules provided in Article 8 apply to the taxation of gains from the disposition of ships or aircraft operated in international traffic (Article 13(4)).

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision, similar to Code section 482, that recognizes the right of each country to make an allocation of income, deductions, credits, or allowances to that country in the case of transactions between related persons to reflect the conditions and arrangements that would have been made between independent persons.

For purposes of the proposed treaty, a person is related to another person if either person owns or controls directly or indirectly the other, or if any third person or persons own or control directly or indirectly both related persons.

If, pursuant to this article, one country includes in the profits of its resident, and taxes accordingly, profits on which a resident of the other country has been subjected to tax in that other country, then the other country, if it agrees that the adjustment reflects arm's-length principles, is to make a correlative adjustment to the amount of the tax charged on its resident on those profits. In determining the correlative adjustment, the other country is to give due regard to the other provisions of the proposed treaty and, if necessary, the competent authorities of the two countries will consult with each other.

The proposed treaty omits the usual provision stating that this article is not intended to limit any law in either country that permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between non-independent persons when such law is necessary to prevent evasion of taxes or to reflect clearly the income of those persons. That provision generally clarifies that the United States retains the right to apply its intercompany pricing rules (Code sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and applicable regulations). It is understood that, notwithstanding the omission of the standard language, that the United States retains the right under the proposed treaty to apply its intercompany pricing and deduction allocation rules.

Article 10. Dividends

In general

This article generally reduces to 20 percent the rate of tax that one of the countries can levy on the gross amount of dividends paid to "portfolio" investors of the other country and to 14 percent the rate of tax on dividends paid to "direct" investors. The proposed treaty provides that the dividend recipient's country of residence may also tax the dividend under its internal laws.

U.S. taxation of dividends paid to foreign persons

The United States generally imposes a 30-percent withholding tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated tax rates, on a net basis. For purposes of the 30-percent tax, U.S. source dividends are dividends paid by a U.S. corporation (other than a corporation that has elected status as a possession corporation under Code sec. 936). Also treated as U.S. source dividends for this purpose are certain dividends paid by a foreign corporation, if at least 25 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business. The U.S. tax imposed on dividends paid by a foreign corporation is often referred to as a "second-level" withholding tax.

For taxable years beginning after December 31, 1986, a U.S. branch of a foreign corporation is subject to a branch profits tax in the United States on any deemed repatriation of the branch's U.S. effectively connected earnings and profits. The branch profits tax rate is 30 percent (but can be reduced or eliminated by treaty), and is levied on the branch's dividend equivalent amount. The branch profits tax provision generally replaces the second-level withholding tax (discussed above) which the United States imposed prior to the 1986 Act.

In addition to the branch profits tax, a 30-percent (or lower treaty rate) tax is levied on any interest allocable to and deducted by the U.S. branch of a foreign corporation.

Tunisian system for taxing dividends

In the past, Tunisian source dividends generally have been subject to the tax on income from movable capital in Tunisia. This tax has been collected through withholding at source, at a rate of 30 percent with respect to bearer shares, and 20 percent with respect to registered shares. It is understood that Tunisia has recently amended its internal laws, and in doing so has reduced (or in some cases eliminated) this tax.

Proposed treaty rules

Under the proposed treaty, dividends paid by a company that is a resident of one country to a resident of the other country are taxable by both countries. The proposed treaty limits the rate of tax

that the payor's country of residence may impose on dividends paid to a beneficial owner in the other country, however. None of the limitations on taxation of dividends apply to taxation of the company in respect of the profits out of which the dividends are paid. The limitation is 20 percent or 14 percent, depending on the relationship between the payor and the payee. The 14-percent rate of source-country tax applies to dividends if the beneficial owner is a company (other than a partnership) that owns at least 25 percent of the voting stock of the company paying the dividends. The 20-percent rate applies to dividends in all other cases.

The proposed protocol clarifies that the 14-percent rate does not apply to dividends paid by a U.S. regulated investment company (RIC) or real estate investment trust (REIT). In the case of dividends paid by a REIT to a beneficial owner that is an individual who owns at least a 25-percent interest in the REIT, the rate of withholding applicable under U.S. law applies (i.e., 30 percent). Otherwise, dividends from RICs and REITs will be taxed by the United States at a 20-percent rate. RICs and REITs are denied the lower treaty rate of withholding tax because they are "pass-through" entities that generally are not taxed on the income they earn.

The proposed treaty defines dividends to mean income from shares, "jouissance" shares or "jouissance" rights, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the internal laws of the distributing company's country of residence. According to the proposed protocol, the term "dividends" also includes income from any income-producing financial transactions, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the internal law of the country in which the income arises.

The limitation contained in the proposed treaty on the rate of withholding tax will not apply if the recipient of the dividend has a permanent establishment or fixed base in the source country and the shares with respect to which the dividend is paid are effectively connected with the permanent establishment or fixed base. In that case, the dividend is taxed as business profits (Article 7) or as income from independent personal services (Article 14), as appropriate. In addition, the saving clause assures that the reduced withholding tax rate does not apply with respect to U.S. source dividends received by U.S. citizens who are resident in Tunisia (Article 22(2)).

Under the proposed protocol, the country in which a corporate resident of the other country has a permanent establishment is authorized to impose a branch profits tax and a branch-level interest tax in accordance with its internal law on the profits attributable to, or interest payments allocable to, the permanent establishment, and on income from real property (Article 6) and related capital gains (Article 13(1)) which are subject to tax in that country. The rates of the branch-level taxes generally are not to exceed 14 percent. In computing net profits which are subject to a branch profits tax, any income tax imposed by the source country on the income of the permanent establishment are allowed as a deduction.

The proposed protocol states that a branch-level tax on interest may be imposed on the excess of interest deducted in determining the profits of the permanent establishment over the actual payments of interest by the permanent establishment. Under U.S. law, a permanent establishment is allowed to deduct an allocable portion of the interest expense of its home office. If the deduction exceeds the amount of interest actually paid by the permanent establishment, the excess deduction is treated as if it were remitted to the home office, subject to the branch-level interest tax.

Article 11. Interest

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short term original issue discount), the United States imposes a 30-percent tax, collected by withholding, on U.S. source interest paid to foreign persons under the same rules that apply to dividends. For purposes of the 30-percent tax, U.S. source interest generally is interest on debt obligations of U.S. persons, other than a U.S. person that meets the foreign business requirements of Code section 861(c) (e.g., an 80/20 company). Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is also subject to a branch level interest tax, which is the tax it would have paid had a wholly owned domestic corporation paid it the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

As well as allowing a taxpayer's country of residence to tax interest income, the proposed treaty generally allows the imposition of a withholding tax at source on interest. The proposed treaty limits the rate of tax to 15 percent of the gross amount of the interest, however, in situations where the interest is beneficially owned by a resident of the other country. This 15-percent rate contrasts with the U.S. model position, not generally achieved, that interest should be exempt from tax at source.

Certain exceptions apply to the general rule that permits both the residence country and, at a limited rate, the source country to tax interest. First, in cases where interest is derived from sources within one country by the government of the other country or its agency or instrumentality which is exempt from tax in its residence country (e.g., the Overseas Private Investment Company of the United States), such interest is exempt from source-country tax under the proposed treaty. Second, interest that is beneficially derived by a bank or similar financial institution with respect to an obligation with a maturity of at least seven years is exempt from tax in the source country. Third, source-country tax exemption is granted to interest paid by the Government of Tunisia (or its political subdivisions or local authorities) to a U.S. resident who provided loans to that government, subdivision, or agency.

The proposed treaty defines "interest" as income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and from bonds, debentures, including premiums and prizes attaching to bonds or debentures. Penalty charges for late payment are not

treated as interest under the proposed treaty. This definition is similar to the definition of interest contained in the U.S. model.

As in the case of dividends, if interest is paid on debt that is effectively connected with a permanent establishment or fixed base in the source country, the interest is taxed as business profits (Article 7) or as income from independent personal services (Article 14), as the case may be. That is, the 15-percent rate limitation and exemptions of this article do not apply. In addition, the reduced withholding tax rate does not apply with respect to U.S. source interest received by U.S. citizens who are resident in Tunisia (Article 22(2)).

The proposed treaty provides a source rule for interest. Interest is sourced within a country if the payor is the government of that country, including its political subdivisions or local authorities, or a resident of that country. If, however, the interest is borne by (i.e., for purposes of computing taxable income, deductible by) a permanent establishment or fixed base that the payor has in one of the treaty countries and the indebtedness was paid or incurred with respect to that permanent establishment or fixed base, interest has its source in that country, regardless of the residence of the payor. Generally, this is consistent with U.S. source rules (Code secs. 861 and 862) which provide as a general rule that interest income is sourced in the country in which the payor is resident.

The proposed treaty addresses the issue of interest charges between related parties by providing that the amount of interest for purposes of applying this article is the amount of arm's-length interest. Where any amount designated as interest paid by a person to any related person (Article 9) exceeds an amount which would have been paid to an unrelated person, the proposed treaty's interest provisions apply only to so much of the interest as would have been paid to an unrelated person. The excess payment may be taxed by each country according to its own law, including the other provisions of the proposed treaty where applicable. For example, excess interest paid to a parent corporation might be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Article 12. Royalties

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on noneffectively connected U.S. source royalties paid to foreign persons. Generally, royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of, or the right to use, intangible assets in the United States.

Tunisia generally imposes a 26.4-percent withholding tax (or in some cases, a 21-percent withholding tax) on Tunisian source royalties paid to nonresident persons.

Under the proposed treaty, royalties derived by a resident of one country from sources within the other country (the "source country") generally are taxable by both the country of residence and the source country; however, the source-country tax rate may not exceed a rate specified by the proposed treaty. Under the saving clause, the reduced withholding tax rate does not apply with re-

spect to U.S. source royalties received by U.S. citizens who are resident in Tunisia (Article 22(2)).

The proposed treaty provides that a maximum source-country tax rate of 15 percent applies to payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, (including cinematographic film or films or tapes used for radio or television broadcasting). In addition, this rate applies to payments of any kind made as consideration for the use of, or the right to use, patents, trademarks, designs, models, plans, secret processes or formulae, or for information concerning industrial, commercial, or scientific experience. Also taxed at a 15-percent rate are gains derived from the sale, exchange, or other disposition of any such property or rights to the extent that the amounts realized on such disposition for consideration are contingent on the productivity, use, or disposition of the property or rights.

A maximum source-country tax rate of 10 percent applies to royalties such as payments by a resident of one country for the use of, or the right to use, industrial, commercial, or scientific equipment, but excluding ships, aircraft, or containers the income from which is exempt from source-country tax under the rules applicable to shipping and air transport (Article 8). The 10-percent rate also applies to payments of any kind received by a resident of one of the countries as remuneration for technical or economic studies, wherever prepared, which are paid out of public funds of the other country (or a political subdivision or local authority), or remuneration for the performance of accessory technical assistance for the use of property or rights described in this paragraph to the extent that such assistance is performed in the country where the payment or the property or right has its source.

As in the case of dividends and interest, if the property or right giving rise to the royalty is effectively connected with a permanent establishment or a fixed base, the royalty is taxed as business profits (Article 7) or as income from independent personal services (Article 14), as appropriate.

As in the case of interest, if a royalty is paid between related persons (Article 9) and exceeds an arm's-length amount, the excess is not treated as a royalty, but may be taxed by each country according to its own law, including the other provisions of the proposed treaty where applicable. For example, excess royalties paid to a parent corporation may be treated as a dividend under local law and thus may be entitled to the benefits of Article 10 of the proposed treaty.

For purposes of the proposed treaty, royalties are sourced in the country in which the property giving rise to the royalty payment is used. In the case of studies, royalties are source in the country of residence of the payor.

Article 13. Capital Gains

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days during

the taxable year. Under the Foreign Investment in Real Propert Tax Act of 1980 ("FIRPTA"), as amended, however, a nonresiden alien or foreign corporation is taxed by the United States on gai from the sale of a U.S. real property interest as if the gain was ef fectively connected with a trade or business conducted in th United States. "U.S. real property interests" include interests i certain corporations holding U.S. real property. In addition, legisla tion has been introduced in Congress that would tax gains realize by foreign persons on dispositions of stock of U.S. corporations i cases where the foreign person is a substantial (i.e., at least 10 per cent) shareholder of the corporation.[9]

The proposed treaty generally provides that gains derived by a resident of one country are exempt from tax by the other country The general exemption does not apply in three situations. In those situations, gains are taxable by both countries (with relief from double taxation provided pursuant to Article 23).

First, a resident of one country who derives gains from the sale exchange, or other disposition of real property referred to in Arti cle 6 (Income from Real Property) that is situated in the other country (the "source country") is not exempt from tax by the source country with respect to such gains. For purposes of the pro posed treaty, a U.S. real property interest (for example, stock in a U.S. real property holding company) is considered real property that is situated in the United States. In conjunction with Article 14, this provision allows the United States to tax any transaction of a Tunisian resident taxable under Code section 897.

Second, gains on the sale, exchange, or other disposition of property that forms a part of the business property of a permanent establishment or a fixed base (including gains on the disposition of the permanent establishment or the fixed base itself) are not exempt from tax in the country where the permanent establishment or fixed base is located. These gains are taxed in that country as business profits (Article 7) or income from independent personal services (Article 14), as appropriate. In addition, as provided in the proposed protocol, a country may also tax gain attributable to a permanent establishment or fixed base even if payments are deferred until after the permanent establishment or fixed base no longer exists. This provision is consistent with Code section 864(c)(6). The tax imposed under Code section 864(c)(7), which allows the United States to tax a disposition of property which occurs subsequent to the time it was attributable to a U.S. trade or business, is not permitted by the proposed treaty or protocol. It is understood that Tunisia does not have an internal rule similar to Code section 864(c)(7).

Third, gain derived by an enterprise from the disposition of certain property used in international shipping and air transportation operations is taxable in Tunisia only if the place of the enterprise's effective management is in Tunisia; the United States may tax such gain only if the enterprise is created under the laws of the United States or any State.

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[9] H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess., (1990).

The article on gains is subject to the saving clause (Article 22(2)). Therefore, as a general rule, the United States may tax its citizens and residents on gains without regard to the provisions contained in the proposed treaty.

Article 14. Independent Personal Services

The United States taxes the income of a nonresident alien individual at the regular graduated tax rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can be a U.S. trade or business (Code sec. 864(b)).

The proposed treaty limits the right of a country to tax income in respect of professional services or other activities of an independent character by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from salaries, wages, and similar remuneration received by employees.

Under the proposed treaty, income from the performance of independent personal services in one country (the "source country") by an individual resident of the other country is exempt from tax in the source country unless (1) the individual is present in the source country for more than 183 days during the taxable year, (2) the individual has a fixed base regularly available to him or her in that country for the purpose of performing the activities, or (3) the gross income derived by the individual during the taxable year exceeds $7,500 or the equivalent amount in Tunisian dinars. If any of these three criteria are satisfied, the source country can tax the individual's income derived from independent personal services performed in that country; however, if only the second criterion is met, only that portion of the individual's income from independent personal services that is attributable to his or her fixed base in that country may be so taxed. In any of the three cases, the country of residence may also tax that income, subject to the proposed treaty's provisions for relief from double taxation (Article 23).

For purposes of this article, independent personal services include all personal services performed by an individual for his or her own account. Independent personal services include, but are not limited to, independent scientific, literary, artistic, educational, or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

This article is modified somewhat by the article on directors' fees (Article 16).

The article on independent personal services is subject to the provisions of the saving clause (Article 22(2)). Therefore, as a general rule, the United States may tax its citizens and residents on income derived from the performance of independent personal services without regard to the provisions contained in the proposed treaty. For example, in the case of such income earned by a U.S. citizen residing in Tunisia, the U.S. tax is not limited by the rules contained in Article 14.

Article 15. Dependent Personal Services

Under the Code, the income of a nonresident alien individual derived from the performance of personal services in the United States is not taxed if the individual is present in the United States for less than 90 days during a taxable year, the compensation is less than $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or for a foreign office or place of business of a U.S. person.

Under the proposed treaty, income derived from labor or personal services performed as an employee in one country (the "source country") by a resident of the other country are not taxable in the source country if three requirements are met: (1) the individual is present in the source country for no more than 183 days during the taxable year; (2) the employer is not a resident of the source country; and (3) the compensation is not borne or reimbursed (i.e., deducted) by a permanent establishment of the employer in the source country. If these requirements are not all met, the source country may tax the individual's income derived from dependent personal services. The source-country tax exemption contained in the proposed treaty is similar to that provided in the U.S. model.

Compensation derived by an employee aboard a ship or aircraft operated in international traffic by an enterprise is taxable by Tunisia only if the place of effective management of the enterprise is in Tunisia; and is taxable by the United States only if the enterprise is created under the laws of the United States or any State.

The rules of this article are modified in some respects for directors' fees (Article 16), pensions (Article 18), and compensation derived as a government employee (Article 19).

The article on dependent personal services is subject to the saving clause (Article 22(2)). Therefore, as a general rule, the United States may tax its citizens and residents on employment income without regard to the provisions contained in the proposed treaty. For example, in the case of such income earned by a U.S. citizen residing in Tunisia, the U.S. tax is not limited by the rules contained in Article 15.

Article 16. Directors' Fees

The proposed treaty contains a special rule for directors' fees. If an individual who is a resident of one country serves as a member of the board of directors of a company that is a resident of the other country, the country of the company's residence may tax him or her on the director's fees derived by that person if those fees are treated by that country as a nondeductible distribution of profits by the corporation. This rule does not cover fixed or contingent payments derived by the individual in his or her capacity as an officer or employee of the corporation. Fees earned by a director that do not meet the specific criteria detailed above are covered by either the article on independent personal services (Article 14) or dependent personal services (Article 15), as appropriate. This article is similar to the corresponding article in the U.S.-Belgium income tax treaty.

Article 17. Artistes and Athletes

The proposed treaty contains a separate set of rules that apply to the taxation of income earned with respect to services performed by public entertainers (such as theater, motion picture, radio, or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and are intended, in part, to prevent entertainers and athletes from using the proposed treaty to avoid paying any tax on their income earned in one of the countries.

Under the proposed treaty, one country (the "source country") may tax entertainers and athletes who are residents of the other country on the income derived from their personal activities performed in the source country if their gross receipts (including reimbursed expenses or expenses borne on their behalf) exceed $7,500 or its equivalent in Tunisian dinars for the taxable year. The comparable annual total in the U.S. model treaty is $20,000 (including reimbursed expenses). Under this provision, for example, if a Tunisian entertainer does not maintain a fixed base in the United States, but performs in the United States (as an independent contractor) during a taxable year for total compensation (including reimbursed expenses) of $7,400, the United States can not tax that income. If however, the entertainer's total compensation for that year is $7,600, the full $7,600 (less appropriate deductions) is subject to U.S. tax.

In addition, the proposed treaty provides that if income in respect of activities performed by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete, but to another person, that income is taxable by the source country. (This provision applies notwithstanding the articles on business profits, independent personal services, and dependent personal services (Articles 7, 14, and 15).) This provision is intended to prevent performers and athletes from avoiding tax in the source country by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income. For purposes of this rule, income of an entertainer or athlete is deemed not to accrue to another person if it is established that neither the entertainer or athlete, nor any related persons, participate directly or indirectly in the profits of such other person. A participation in profits includes the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions and other distributions.

The artistes and athletes article of the proposed treaty is subject to the provisions of the saving clause (Article 22(2)). Therefore, as a general rule, the United States is permitted to tax its citizens and residents on income earned as an entertainer or athlete without regard to the provisions contained in the proposed treaty. For example, in the case of such income earned by a U.S. citizen resident in Tunisia, the U.S. tax on that income is not limited by the provisions of Article 17.

Article 18. Pensions, Etc.

Under the proposed treaty, pensions and other similar remuneration paid to an individual resident of one country in consideration of past employment in the other country (the "source" country) are exempt from tax by the source country. This rule is similar to the rule contained in the U.S. model. The term "pension" is not defined by the proposed treaty; thus, the definition of that term is left up to the local laws of the two countries. This article does not apply to a pension paid with respect to government service (Article 19).

Social security payments and similar payments (including, for example, payments under the Railroad Retirement Act) paid by one country to a resident of the other country are taxable by both countries under the proposed treaty. Under this provision, the United States is permitted to tax U.S. social security payments to U.S. persons residing in Tunisia. To the extent that it does so, thereby causing the payments to be taxed in both countries, Tunisia is required by Article 23 to grant the taxpayer relief from double taxation in the form of a credit for taxes paid to the United States. This rule safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in Tunisia from double taxation.

The proposed treaty provides that annuities are taxable only in the recipient's country of residence. "Annuities" are defined as stated sums paid periodically at stated times during life or during a specified number of years, under a contractual obligation.

In addition, the proposed treaty provides that alimony payments made by a resident of one of the countries to a resident of the other country are exempt from tax in the payor's country of residence. "Alimony" is defined as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of his or her country of residence.

The proposed treaty further provides that periodic child support payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support, paid by a resident of one of the countries to a resident of the other country are exempt from tax in both countries, and are not deductible by the payor.

These rules are subject to the saving clause (Article 22(2)). Thus, for example, a country may tax alimony received by a citizen of that country residing in the other country.

Article 19. Governmental Functions

Under the proposed treaty, remuneration (other than a pension) paid from public funds of one country (or its political subdivisions or local authorities) to an individual who is a citizen of that country for labor or personal services performed in the discharge of governmental functions is exempt from tax by the other country. A similar rule is found in the U.S. model.

As a general rule, any pension paid out of government funds of one of the countries to a resident of the other country individual in

respect of labor or personal services rendered to that country in the discharge of governmental functions is taxable only by the recipient's country of residence. Thus, for example, if the U.S. Government makes pension payments to a resident of Tunisia, only Tunisia may tax those payments. This rule is a departure from the U.S. model, and represents a concession to Tunisia's position that its residents deriving pensions (whether from public or private sources) should be taxed on the same basis without regard to where the pension originates. As an exception to this general rule, the country whose government makes such payments is permitted to tax those payments if they are made to a citizen of the paying country.

The rules of this article generally are subject to the saving clause (Article 22(2)), except in the case of a person who is not a citizen of, or an immigrant in, the country conferring benefits to that person under Article 19.

The proposed treaty clarifies that this article does not apply to payments made in respect of services rendered in connection with a trade or business carried on by one of the countries. In such a case, the provisions of the articles dealing with personal services (Articles 14 and 15) or artistes and athletes (Article 17) apply, as appropriate.

Article 20. Students and Trainees

The proposed treaty provides special host-country tax exemptions for income of a resident of one country who visits the other as a student, apprentice, or trainee. These treaty exemptions differ in some respects from those provided in the U.S model. They are similar to the exemptions incorporated in a number of older U.S. income tax treaties.

Under the proposed treaty, an individual who is a resident of one country immediately before entering the other country (the "host country"), and who is present in the host country for the purpose of his or her full-time education or training is exempt from host-country tax on certain items for a period not to exceed five years beginning with that person's date of arrival in the host country. The items to which the exemption applies include (1) payments arising outside of the host country for the purpose of the individual's full-time education or training, (2) a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization for the purposes of studying or doing research, and (3) income from personal services performed in an amount not in excess of $4,000 or its equivalent in Tunisian dinars for any taxable year. Any income in excess of the $4,000 threshold is taxable by the host country in accordance with domestic law, taking into account any personal exemptions and deductions allowable under domestic law.

The rules of this article generally are subject to the saving clause (Article 22(2)), except in the case of a person who is not a citizen of or an immigrant in the country conferring benefits to that person under Article 20.

Article 21. Other Income

This article is a catch-all article intended to cover items of income not specifically covered in other articles, and to assign the right to tax third-country income to only one of the countries. It applies to income from third countries as well as income from the United States and Tunisia.

As a general rule, items of income not otherwise dealt with in the proposed treaty that are derived by residents of a country are taxable only by that country. The proposed treaty thus gives the United States the sole right to tax income arising in a third country and paid to a resident of the United States. If the income is attributable to a permanent establishment or fixed base in the treaty country (the "source country") that is not the residence country, however, the source country may also tax it. In addition, income from real property that is not subject to another treaty provision is taxable only in the country of residence of the person earning the income, whether or not the real property income is attributable to a permanent establishment or fixed base in the other treaty country. The effect of this provision is to allow the residence country to tax income from real property located in a third country, even if that income somehow is attributable to a permanent establishment or fixed base in the treaty country not of residence.

This provision is subject to the saving clause (Article 22(2)). Thus, U.S. citizens who are Tunisian residents would continue to be subject to U.S. taxation on their worldwide income.

Article 22. General Rules

Restriction of domestic-law benefits

The proposed treaty contains the rule found in other U.S. tax treaties clarifying that its provisions do not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance otherwise accorded by the domestic laws of either country or any other agreement between the two countries. Thus, the proposed treaty applies only where it benefits taxpayers. In cases where a treaty provision would have a detrimental effect on a taxpayer, the taxpayer may elect to utilize the rules of domestic law or of another agreement between the two countries.

Saving clause

Like all U.S. income tax treaties, the proposed treaty contains a "saving clause." Under this clause, with exceptions described below, the United States reserves the right to tax its citizens and residents and Tunisia reserves the right to tax its citizens and residents, notwithstanding any provision of the proposed treaty. By reason of the saving clause, the United States generally continues to tax its citizens who are residents of Tunisia as if the proposed treaty were not in force. "Residents," for purposes of the proposed treaty (and thus for purposes of the saving clause), include corporations and other entities as well as individuals (Article 4 (Fiscal Domicile)). Under Code Section 877, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes, is, in certain cases, subject to U.S. tax for a period of 10 years following the loss of citizen-

ship. The proposed treaty contains the standard provision found in the U.S. model and most recent treaties specifically reserving the United States' right to tax such former citizens. (Even absent a specific provision, the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).)

Exceptions to the saving clause are provided for the benefits conferred by the articles dealing with correlative adjustments to be made by one country in accordance with adjustments made by the other country in the case of certain transactions between related persons (Article 9(2)), the general rule prohibiting the proposed treaty from restricting benefits conferred under domestic law (Article 22(1)), relief from double taxation (Article 23), non-discrimination (Article 24), and mutual agreement procedures (Article 25). The benefits of those articles are conferred by each country on its own citizens and residents as well as the citizens and residents of the other country. In addition, the benefits conferred by the articles dealing with the taxation of income received by government employees (Article 19) and students and trainees (Article 20) are provided by each country to its residents who are neither citizens of, nor have immigrant status in, that country. A person has "immigrant status" in the United States if he or she has been admitted to the United States as a permanent resident under U.S. immigration laws (that is, he or she holds a "green card").

Other than under the foregoing exceptions to the saving clause, U.S. citizens and residents benefit under the proposed treaty only as the result of the agreement by Tunisia to reduce its rate of tax on their income or exempt their income from tax; they do not benefit under the proposed treaty from reductions in tax or tax exemptions granted by the United States. Similarly, except as noted above, Tunisian citizens and residents benefit under the proposed treaty only as the result of the agreement by the United States to reduce its rate of tax on their income or exempt their income from tax.

Article 23. Relief from Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that is subject to tax in the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for oil and gas extraction income, passive income, high withholding tax interest, financial services income, shipping income, dividends

from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90-percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation when dividends are received by the U.S. corporation from the foreign corporation (the "indirect foreign tax credit") (Code sec. 902). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of taxes to be credited. However, if the foreign corporation is not a controlled foreign corporation (Code sec. 957), then the dividends received from such corporation, and the foreign taxes attributable thereto, are included in a separate foreign tax credit limitation category.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person is taxable on business income, a business may be taxed by two countries as if it was engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double taxation problem is dealt with in other articles that limit the right of a source country to tax income. This article provides further relief where both Tunisia and the United States would still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that the article applies.

The proposed treaty provides separate rules for relief from double taxation for the United States and Tunisia.

United States

Under the proposed treaty, the United States provides its citizens and residents with a foreign tax credit against their U.S. income tax for the appropriate amount of Tunisian tax paid. The credit is computed in accordance with the provisions and subject to the limitations of U.S. law applicable to the year in question.[10] The credit may not exceed the limitations provided by U.S. law for the taxable year.

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[10] It is understood that, for purposes of the U.S. alternative minimum tax, the foreign tax credit allowable is limited, under the proposed treaty, to 90 percent of the pre-credit liability for such tax, as provided under U.S. law.

The proposed treaty also allows the U.S. indirect foreign tax credit to a U.S. corporate shareholder of a Tunisian company receiving dividends from that company if the U.S. corporation owns 10 percent or more of the voting stock of the Tunisian company. The credit is allowed for Tunisian income taxes paid by or on behalf of the Tunisian company on the profits out of which the dividends are paid.

All of the Tunisian taxes listed in Article 2(2)(b) and 2(3) are considered creditable taxes under this provision.

Tunisia

The proposed treaty requires that Tunisia provide its residents a credit against their Tunisian tax for the appropriate amount of income taxes paid to the United States. The amount of this credit is limited, however, to that portion of the Tunisian pre-credit income tax that is attributable to the income which is taxable in the United States.

Source rules

For purposes of applying both the U.S. and Tunisian foreign tax credits under the proposed treaty, a general source rule is provided. This general rule states that income derived by a resident of one country which, under the proposed treaty, is subject to tax in the other country (other than solely by reason of the taxpayer's citizenship), is sourced in the other country. For purposes of the foreign tax credit provided by the United States, notwithstanding this general rule, the credit is subject to such source rules of U.S. law as apply solely for the purposes of limiting the foreign tax credit.

The 1984 Act amended the foreign tax credit limitation rules to prevent U.S. persons from treating as foreign source income dividends, interest, and certain other income derived through a foreign corporation, a significant part of whose income arose in the United States. As mentioned above, the proposed treaty provides that the United States is required to credit taxes paid to Tunisia only in accordance with the provisions and subject to the limitations of the law of the United States, as in force from time to time. Furthermore, the proposed treaty provides that in applying the United States credit in relation to taxes paid to Tunisia, the treaty's source rule applies, subject to such source rules in domestic law as apply solely for the purposes of limiting the foreign tax credit. Because the 1984 Act change is a U.S.-law source rule that applies solely for purposes of limiting the foreign tax credit, it is understood that the Treasury Department interprets the proposed treaty not to override the 1984 amendment.

The saving clause (Article 22(2)) does not apply to this article. Thus, the United States is required by the proposed treaty to provide a foreign tax credit to its citizens and residents, notwithstanding any more restrictive provision contained in the Code.

Article 24. Non-Discrimination

The proposed treaty contains a non-discrimination article relating to all taxes of every kind imposed by one of the countries or by their political subdivisions or local authorities. It is similar to the

non-discrimination article in the U.S. model treaty and to prov sions that have been embodied in other recent U.S. income ta treaties.

Generally under the proposed treaty, one country (the "sourc country") may not discriminate by imposing more burdensom taxes or related requirements on citizens of the other country (wh are resident in the source country) than it imposes on its own res dent citizens in similar circumstances. For purposes of U.S. ta however, a U.S. national who is not a resident of the United State and a Tunisian national who is not a resident of the United State are not in similar circumstances, because the U.S. national is sul ject to U.S. tax on his or her worldwide income. Contrary to th corresponding provision in the U.S. model, this non-discriminatio rule is limited to persons who are resident in either the Unite States or Tunisia.

The proposed treaty adopts the OECD model treaty definition "nationals." Nationals are individuals possessing the citizenship the United States or Tunisia and all legal persons deriving thei status as such from the laws in force in the United States or Tun sia. Under the U.S. model treaty, by comparison, only U.S. citizen qualify as U.S. nationals for purposes of obtaining non-discrimin tion benefits.

Generally, the proposed treaty prohibits a source country fro imposing less favorable taxation on permanent establishments residents of the other country than it imposes on its comparabl residents carrying on the same activities. This rule does not limit source country's ability to levy a tax on branch-level profits or i terest of a permanent establishment of a resident of the othe country (Article 10(7)). Nor does it limit a source country's abilit to collect a tax owed by residents of the other country by withhol ing at source (including the rules of Code section 1446 that requi a partnership to withhold certain amounts attributable to foreig partners) since such a procedure is considered a reasonable mech nism for collecting the tax due from persons not continuall present in the source country.

Each country is required (subject to the arm's-length pricin rules of Articles 9(1) (Associated Enterprises), 11(8) (Interest), an 12(5) (Royalties)) to allow its residents to deduct interest, royaltie and other disbursements paid by them to residents of the othe country under the same conditions that it allows deductions fo such amounts paid to residents of the same country as the payo

The rule of non-discrimination also applies to corporations of on country that are owned in whole or in part by residents of th other country. A corporation resident in one country, the capital which is wholly or partly owned or controlled, directly or indirec ly, by one or more residents of the other country, is not to be sul jected in its country of residence to any taxation or any connecte requirements that are other or more burdensome than the taxatio and connected requirements that the corporation's residence cour try imposes or may impose on its corporations which carry on th same activities and which are owned or controlled by its resident Although certain provisions of U.S. law relating to the taxation gain on the liquidation of a subsidiary and to the taxation of sul chapter S corporations distinguish between U.S.-owned and foreign

owned corporations, it is understood that these provisions are not considered discriminatory under the proposed treaty.

Under this article of the proposed treaty, a country is not required to grant to residents of the other country the personal allowances, reliefs, or reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents.

The saving clause (Article 22(2)) which allows the country of residence or citizenship to tax income notwithstanding certain treaty provisions does not apply to the non-discrimination article.

Article 25. Mutual Agreement Procedure

In general

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of the United States and Tunisia to consult together in an attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under the proposed treaty, a resident of one country who considers that the actions of one or both of the countries will cause him or her to pay tax not in accordance with the proposed treaty may present the case to the competent authority of the country of his or her residence, or in cases where the relief from double taxation article applies (Article 23), an aggrieved person may also present his or her case to the competent authority of the country of which that person is a resident or national. The competent authority then determines whether the claim has merit. If it determines that the claim does have merit, the competent authority will endeavor to seek a solution independently or come to an agreement with the competent authority of the other country with a view to the avoidance of taxation that is contrary to the provisions of the proposed treaty.

The competent authorities may also consult together to endeavor to mutually agree on any difficulty or doubt arising in applying the proposed treaty; for example, in the case of an uncertain interpretation or application of the proposed treaty. In addition, they may consult together for the purpose of settling upon a common definition of a term used in the proposed treaty or to a characterization of a particular item of income.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. When it seems advisable for the purpose of reaching an agreement, they may meet for an oral exchange of opinions. These provisions clarify that it is not necessary to go through normal diplomatic channels in order to discuss problems arising in the application of the proposed treaty. They also remove any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Tunisia.

In the event that the competent authorities reach an agreement under this mutual agreement article, the proposed treaty provides for the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. However, this article does not authorize the imposition of additional taxes after the statute of limitations has run.

Limitation on benefits

Article 25 also contains rules to prevent "treaty-shopping" by persons (other than individuals) not intended to benefit from the proposed treaty. In order to receive treaty benefits, a person other than an individual must satisfy one of the following three tests. Under the first test, which does not apply to individuals, more than 50 percent of the beneficial interest in a person that is a resident of one of the countries (or, in the case of a company, more than 50 percent of the number of shares of each class of the company's stock) must be owned, directly or indirectly, by any combination of the following persons: individuals who are residents of the United States or Tunisia, the government of either country (or their political subdivisions or local authorities), or U.S. citizens. Moreover, the income of such person must not be used in substantial part, directly or indirectly, to meet liabilities (including deductible expenses such as interest and royalty payments) to persons other than those listed above. The purpose of this latter requirement, generally referred to as a "base erosion" rule, is to prevent residents of third countries from utilizing a company resident in either the United States or Tunisia which meets the ownership requirements, but pays out a substantial portion of its income to such third country residents in the form of deductible expenses.[11]

Under the second test, benefits provided by the proposed treaty are authorized to persons (regardless of the place of residence of their owners) that carry on an active business in the treaty country of which they are residents and derive income from the other treaty country in connection with that active business. Under this test, making or managing investments does not constitute an active business unless carried on by a bank or insurance company in its normal course of business.

The third test permits treaty benefits to be obtained by a company that is a resident of either the United States or Tunisia, and whose principal class of shares is substantially and regularly traded on a recognized stock exchange (e.g., the NASDAQ System, any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, the Tunisian stock exchange (Bourse de Valeurs Mobilieres), and any other exchange agreed upon by the competent authorities of the two countries).

Prior to any case where a person is to be denied benefits under the proposed treaty, the competent authorities of the two countries

[11] This base erosion rule is not intended to disallow treaty benefits to companies resident in either of the treaty countries that, for business reasons, purchase supplies from third country residents. The rule applies only with respect to deductible expenses paid by the company to such persons, not to the cost of goods sold.

are required to consult with one another. This rule does not imply that an agreement must be reached by the competent authorities; rather, it places a requirement on a competent authority to notify the other of its decision to limit treaty benefits of a person, and to provide support for why such a decision was reached.

In a case where a person fails all three tests discussed above, it may, nevertheless, be granted treaty benefits if the competent authority of the country in which the person's income arises so determines. This rule provides the competent authorities with some flexibility if a case arises where the tests described above cause an unintended denial of benefits.

Article 26. Exchange of Information

Article 26 forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the proposed treaty. It is similar to the corresponding article of the U.S. model treaty but differs from the U.S. model in certain respects.

The proposed treaty provides for the exchange of information that is pertinent to carrying out the provisions of the proposed treaty or the provisions of the domestic laws of the two countries concerning taxes to which the proposed treaty applies. Similar to the U.S. model, the proposed treaty provides that third-country residents are covered by the exchange of information rules.

Any information exchanged under this article is to be treated as secret in the same manner as information obtained under the domestic laws of the country which receives the information. Exchanged information may be disclosed only to persons (including courts and administrative bodies) concerned with the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies. The proposed treaty further provides that such persons may use the information only for the purposes specified in the proposed treaty. In addition, however, they may disclose the information in public court proceedings or judicial decisions. Persons concerned with the administration of taxes include legislative bodies involved in oversight of the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider to be necessary to carry out their oversight responsibilities.

The proposed treaty contains limitations on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with its laws and administrative practices or to supply information which is not obtainable under its laws or in the normal course of its administration. Moreover, a country is not required to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Upon an appropriate request for information by one country, the requested country is to obtain the information to which the request

relates in the same manner and to the same extent as if its tax were at issue.

The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of the publication by its respective country of any material concerning the application of the proposed treaty, including legislation, regulations, rulings, or judicial decisions.

Article 27. Diplomatic and Consular Officials

The proposed treaty contains the usual provision stating that it is not to affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or the provisions of special agreements. This provision is intended to make clear that the proposed treaty will not defeat any exemption from tax that a host country may otherwise grant unilaterally or by agreement to the salaries of diplomatic officials of the other country.

Like the corresponding provision found in the U.S. model and most U.S. treaties, this provision is fully subject to the saving clause.

Article 28. Entry into Force

The proposed treaty is to be ratified and instruments of ratification exchanged in Washington, D.C. as soon as possible. The proposed treaty will enter into force upon the exchange of the instruments of ratification. It takes effect with respect to taxes withheld at source for amounts paid or credited on or after the earlier of the first day of January following the exchange of instruments of ratification or the first day of the fourth month following the exchange of instruments of ratification. With respect to other taxes, the proposed treaty takes effect for taxable years ending on or after December 31st of the year during which the exchange of instruments of ratification takes place.

Article 29. Termination

The proposed treaty is to remain in force indefinitely, but either country may terminate it at any time after five years from its entry into force by giving at least six months' notice, through diplomatic channels, prior to the end of any calendar year. If a termination occurs, it is effective with respect to income of calendar or taxable years beginning (or, in the case of taxes payable at the source, payments made) on or after the January 1st next following the expiration of the six-month period.

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